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In the Supreme Court of the United States

OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRED L. ENGLE, ET UX.

PHILIP D. FARMAR, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT (FORMERLY THE UNITED STATES COURT OF CLAIMS)

BRIEF FOR THE COMMISSIONER IN NO. 82-599 AND FOR THE UNITED STATES IN NO. 82-774

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QUESTION PRESENTED

Section 613A(c)(2)(A) of the Internal Revenue Code of 1954 (26 U.S.C.) allows a percentage depletion deduction to be computed with respect to the "average daily production of * * * oil or * * * gas," defined in terms of production "for any taxable year."

The question presented is whether the taxpayers, who assigned oil and gas leases partly in consideration of lease bonuses or advance royalties, are entitled to a deduction for percentage depletion under Section 613A with respect to such payments, even though the payments were not based upon production of oil and gas during the taxable years in issue.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statutes involved	3
Statement	3
Summary of argument	9
Argument:	
A taxpayer is not entitled to percentage depletion deductions for payments which are not attributable to oil or gas production	13
A. The 1975 Act changed the tax law to condition the percentage depletion deduction upon actual production of oil or gas during the taxable year	13
B. The plain language of Section 613A of the Code precludes a claim of percentage depletion with respect to lease bonuses or advance royalties that are not based upon production of oil and gas during the taxable year	18
C. The legislative history of Section 613A supports the Commissioner's interpretation	24
Conclusion	34

TABLE OF AUTHORITIES

Cases:

Anderson v. *Helvering*, 310 U.S. 404	18
Bingler v. *Johnson*, 394 U.S. 741	33
Bobsee Corp. v. *United States*, 411 F.2d 231	31
Burnet v. *Harmel*, 287 U.S. 103	15, 18
Burton-Sutton Oil Co. v. *Commissioner*, 328 U.S. 25	14
Commissioner v. *Rowan Drilling Co.*, 130 F.2d 62	14
Douglas v. *Commissioner*, 322 U.S. 275	15

Cases—Continued — Page

Gemsco, Inc. v. *Walling*, 324 U.S. 244 ..... 12, 27
Getty Oil Co. v. *United States*, 399 F.2d 222 18
Glass v. *Commissioner*, 76 T.C. 949 ..... 22, 33
Helvering v. *Morgan's Inc.*, 293 U.S. 121 26
Helvering v. *Twin Bell Oil Syndicate*, 293 U.S. 312 14
Herring v. *Commissioner*, 293 U.S. 322 ..... 9, 15
Monsanto Co. v. *Tyrrell*, 537 S.W.2d 135 20
National Muffler Dealers Association v. *United States*, 440 U.S. 472 ..... 13, 33
Old Colony R.R. v. *Commissioner*, 284 U.S. 552 21
Palmer v. *Bender*, 287 U.S. 299 15
Rogers v. *Osborn*, 152 Tex .540, 261 S.W.2d 311 20
Shamrock Oil & Gas Corp. v. *Commissioner*, 35 T.C. 979 18
Snead v. *Commissioner*, 119 F.2d 767, cert. denied, 314 U.S. 686 15
Tabor v. *Ulloa*, 323 F.2d 823 21
United States v. *Correll*, 389 U.S. 299 ..... 13, 33

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)):
Section 611 3
Section 611(a) 13
Section 612 14
Section 613 ..... 3, 14, 16, 17
Section 613(a) 4
Section 613(b) 14
Section 613(d) 16, 17
Section 613A ..... *passim*
Section 613A(a) 17, 29
Section 613A(b) 16, 17
Section 613A(b)(2)(A) 21
Section 613A(b)(2)(B) 21
Section 613A(c) 16, 17, 22, 25
Section 613A(c)(1) 9, 10, 16, 19, 22
Section 613A(c)(1)(A) 9, 10, 19, 23, 24
Section 613A(c)(1)(B) 9, 19, 23
Section 613A(c)(2) 10, 19, 22

Statutes and regulations—Continued — Page

Section 613A(c)(2)(A) 16, 31
Section 613A(c)(2)(B) 16
Section 613A(c)(3) 10, 19, 22
Section 613A(c)(3)(A)(ii) 19, 22
Section 613A(c)(3)(B) 10, 16, 17, 22, 23
Section 613A(c)(4) 10, 17, 19
Section 613A(c)(5) 10, 16, 19
Section 613A(c)(6) 10, 19, 20
Section 613A(c)(7) 10, 19, 20
Section 613A(c)(8)(D)(iv) 17
Section 613A(c)(9) 10, 19, 20
Section 613A(c)(10) 10, 19
Section 613A(c)(11) 20
Section 613A(e)(4) 20

Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 *et seq.* 5
Section 501, 89 Stat. 47 9
Section 501(a), 89 Stat. 47 ..... 9, 16, 25
Section 501(b)(1), 89 Stat. 53 ..... 9, 16

Treasury Regulations on Income Tax (1954 Code), 26 C.F.R.:
Section 1.611-1(b)(1) 14
Section 1.611-2(a) 14

Miscellaneous:

Bravenec, *Continued Availability of Percentage Depletion of Oil and Gas*, 23 Oil & Gas Tax Q. 204 (1975) 20, 21
C. Breeding & A. Burton, *Income Taxation of Oil and Gas Production* 18
F. Burke, Jr. & R. Bowhay, *Income Taxation of Natural Resources* (1982) 3, 21
121 Cong. Rec. (1975):
pp. 4600-4659 28
p. 4606 28
pp. 4622-4652 12
p. 4631 28
p. 4646 28
pp. 4651-4652 25

Miscellaneous—Continued Page

pp. 6903-6905 12
pp. 7218-7229 12
pp. 7238-7248 12
pp. 7263-7285 12
p. 7277 27
p. 7278 28
pp. 7772-7813 12
p. 7777 28
p. 7795 29
p. 7799 28
p. 7807 28
p. 7813 25
p. 8128 28
pp. 8128-8129 12
p. 8860 12
p. 8924 30
p. 8944 28

H.R. 17488, 93d Cong., 2d Sess. (1974) 11, 12, 24, 25, 26, 27, 31, 32

H.R. 2166, 94th Cong., 1st Sess. (1975) 12, 26, 27

H.R. Conf. Rep. No. 94-120, 94th Cong., 1st Sess. (1975), *reprinted in* 1975-1 Cum. Bull. 624 ..... 29, 30

H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. (1974) 11-12, 23, 26

Hearings on H.R. 2166 Before the Subcomm. on Energy of the Senate Comm. on Finance, 93d Cong., 2d Sess. (1975) 27

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Section 1.163A-3(a)(4), 42 Fed. Reg. 24281.... 32
Section 1.613A-7(f), 42 Fed. Reg. 24287 24
Section 1.613A-7(f)(1), 42 Fed. Reg. 24287.... 32

Rev. Rul. 81-44, 1981-1 Cum. Bull. 384 33

Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976 (H.R. 10612)*, 1976-3 (Vol. 2) Cum. Bull. 1 31

Miscelloneous—Continued Page

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OPINIONS BELOW

No. 82-599. The opinion of the court of appeals (Pet. App. 1a-15a [1]) is reported at 677 F.2d 594. The opinion of the Tax Court (Pet. App. 16a-56a) is reported at 76 T.C. 915.

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[1] "Pet. App." refers to the appendix in No. 82-599.

No. 82-774. The opinion of the Court of Claims (Pet. App. 58a-73a) is reported at 689 F.2d 1017.

JURISDICTION

No. 82-599. The judgment of the court of appeals (Pet. App. 57a) was entered on May 7, 1982. On July 23, 1982, Justice Stevens extended the time within which to file a petition for a writ of certiorari to and including October 4, 1982. The petition was filed on that date and granted on January 10, 1983. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

No. 82-774. The opinion of the Court of Claims (Pet. App. 73a) was filed on September 22, 1982, and judgment was entered on that day. The petition for a writ of certiorari was filed on November 5, 1982, and was granted on January 10, 1983 (J.A. 53). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).[2]

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[2] 28 U.S.C. 1255 was repealed effective October 1, 1982, by Sections 123 and 402 of the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 36, 57. Although the judgment of the Court of Claims was rendered prior to that date, the petition was not filed until after Section 1255 had been repealed. In addition, none of the provisions of Section 403 of the Federal Courts Improvement Act (96 Stat. 56), which governs the transfer of pending cases from the Court of Claims, appears to address the availability of certiorari review of cases decided prior to October 1, 1982, but not filed in this Court until after that date. Nevertheless, we assume that for purposes of certiorari review this case may be deemed to have been automatically transferred to the new Federal Circuit on October 1, 1982, and that the jurisdiction of this Court may therefore properly be invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The pertinent parts of Sections 611, 613 and 613A of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in Pet. App. 74a-78a.

STATEMENT

No. 82-599. During 1975, respondent Fred Engle [3] acquired two oil and gas leases covering a total of 240 acres of land in Wyoming. Respondents assigned the leases to different parties in October 1975, and retained an overriding royalty [4] in each case. As part of

[3] Fred Engle purchased the properties, but both respondents were parties to the assignments in October 1975 (Pet. App. 17a & n.3).

[4] A royalty paid on a mineral lease usually represents an agreed percentage in kind or in value of the production from the property free of the expense of production. See *infra* p. 18 n.12. The term "royalty" was used by the courts below in a more specific sense to refer to the advances received by the Engles on their overriding royalties (Pet. App. 17a n.2). An "overriding royalty" has been described as follows:

> An overriding royalty is similar to a royalty in that, for Federal tax purposes, each is a right to minerals in place that entitles its owner to a specified fraction of production, in kind or in value, and neither is burdened with the costs of development or operation. They differ in that an overriding royalty is created from the operating interest, and its term is co-extensive with that of the operating interest from which it was created.
>
> The overriding royalty may be carved out or retained. It is said to be carved out if the owner of the working interest assigns a right to a fractional share of production free and clear of development and operating expense. It is retained if the lessee assigns the working interest and retains a fractional share of production free of development and operating costs.

F. Burke, Jr. & R. Bowhay, *Income Taxation of Natural Resources* ¶ 2.05 (1982).

Because the technical differences between overriding royalties and royalties are not at issue here, we refer to the advance payments received by the Engles as "royalties."

the consideration for the assignments, respondents received a total of $7,600 as advance royalties in 1975. This $7,600 was the only income respondents received from the properties in 1975. During that year, there was no discovery or exploratory work on the properties covered by the leases, and there was accordingly no gas or oil production on the properties (Pet. App. 2a, 16a-17a).

On their joint federal income tax return for 1975, respondents claimed a percentage depletion deduction equal to 22% of the $7,600 advance royalties they received (Pet. App. 2a). On audit, the Commissioner of Internal Revenue disallowed the deduction. The Commissioner determined that respondents were not entitled to a percentage depletion deduction with respect to the $7,600 advance royalties, because there was no "average daily production" of oil or gas in 1975 as required by Section 613A(c) of the Internal Revenue Code of 1954 (26 U.S.C.) (Pet. App. 76a-78a).

Respondents thereupon brought this proceeding in the Tax Court seeking a redetermination of the deficiency in their income tax arising as a result of the Commissioner's disallowance of their depletion deduction. In a reviewed decision with one dissent, the Tax Court upheld the Commissioner's determination (Pet. App. 16a-56a). It first noted that under the pre-1975 law, a taxpayer could claim either cost or percentage depletion with regard to income realized from the property.[5] Since the prior statutory allowance turned on the existence of income from the property, payments made without regard to actual production —such as advance royalties or lease bonuses—had been eligible for the percentage depletion allowance

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[5] We discuss the meaning of the terms "cost depletion" and "percentage depletion" *infra* pp. 13-14 & nn.8, 9.

(Pet. App. 19a). However, in 1975, Congress changed the rule. Pursuant to the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 *et seq.*, which added Section 613A to the 1954 Code, Congress generally eliminated the percentage depletion allowance for oil and gas wells. A narrow exception for domestic independent producers and royalty owners preserved the percentage depletion allowance, and tied the new oil and gas percentage depletion allowance to the existence of "average daily production." Since there had been no production of oil or gas on the properties covered by respondents' leases, the Tax Court ruled that respondents were not entitled to a percentage depletion allowance (Pet. App. 31a). As the Tax Court characterized the 1975 statutory amendment, "[i]t is difficult to conceive what language Congress could have chosen to state more clearly a requirement tying the allowance of percentage depletion to the actual production of oil or gas on an annual basis" (*id.* at 30a; emphasis omitted).

The court of appeals reversed (Pet. App. 1a-15a). After examining the statutory language, the court found the arguments of both parties to be "reasonable interpretations" and found "[t]he legislative history [to be] of little help in resolving the statutory ambiguity" (*id.* at 11a). It nevertheless rejected the government's reliance upon the explicit statutory phrase "average daily production" as evidencing a requirement that there be actual extraction of oil or gas during the taxable year for which the percentage depletion allowance is claimed. Instead, the court viewed Congress' desire to retain percentage depletion for "small producers" as equally persuasive. Hence, the court attributed to Congress the intent to retain the pre-1975 law with respect to advance royalties paid

to small producers, and to permit percentage depletion as long as there is oil or gas produced at some point during the term of the lease.

No. 82-774. Petitioners A.A. Sugg and Philip D. Farmar [6] owned undivided percentage interests in a mineral estate of approximately 46,514.65 acres of land located in Irion County, Texas (Pet. App. 1a; Stip. para. 5, J.A. 5-6).[7]

On December 1, 1975, petitioners each leased the Irion property for an initial term of five years to Allied Chemical Corporation and Florida Gas Exploration Company (Stip. paras. 6, 19, J.A. 7, 8). Under the agreements, petitioners reserved the right to receive as royalties 20% of all oil and gas produced and sold from the property or 20% of the value of all oil and gas produced from the leased premises (Stip. paras. 7, 20, J.A. 6, 8).

On December 12, 1975, the parties also executed deferred bonus agreements, under which petitioners were entitled to receive a bonus computed at the rate of $45 per mineral acre for the execution and delivery of the December 1, 1975, lease agreements (Stip. paras. 8, 21, J.A. 6, 8). The bonus amounts were

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[6] Philip D. Farmar, his children, and A.A. Sugg were the owners of the mineral interest (see Stip. paras. 5, 16, 17, J.A. 5-6, 7). The Farmar children are not parties to this action. Marian J. Farmar and Mary A. Sugg are parties to this suit solely because they filed joint returns with their spouses. For convenience, references to "petitioners" are to Philip D. and Marian J. Farmar and A.A. and Mary A. Sugg, collectively.

[7] Petitioner A.A. Sugg owned an undivided 50.52% interest; petitioner Philip D. Farmar and his four children owned the remaining 49.48%, in respective shares of 79.63% and 20.37% (Stip. para. 17, J.A. 7).

payable even if no oil or gas was produced from the property (Stip. paras. 10, 23, J.A. 6-7, 9). The lease bonuses were not returnable if the lessees abandoned the property (Stip. para. 32, J.A. 10; see also Stip. para. 33, J.A. 11), and did not affect the amount of royalties to which the lessors were entitled (Stip. paras. 10, 23, J.A. 6-7, 9).

Under the terms of his deferred bonus agreement, petitioner Sugg was entitled to receive an amount of $1,057,543.60, payable in three installments as follows (Stip. para. 9, J.A. 6):

On or before December 25, 1975	$ 1,000.00
Between January 10 and January 20, 1976	528,271.80
Between January 10 and January 20, 1978	528,271.80
	$1,057,543.60

In accordance with Sugg's deferred bonus agreement, he received a payment of $528,271.80 in January 1976. He reported this amount as "oil and gas bonus" income on his 1976 joint income tax return, and claimed a 22% depletion allowance with respect to this amount (Stip. para. 11, J.A. 7).

Under the deferred bonus agreement, petitioner Farmar and his children were entitled to receive the following amounts (Stip. para. 22, J.A. 8):

On or before December 25, 1975	$ 5,000.00
Between January 10 and January 20, 1976	257,653.90
Between January 10 and January 20, 1977	257,653.90
Between January 10 and January 20, 1978	257,653.90
Between January 10 and January 20, 1979	257,653.90
	$1,035,615.60

Pursuant to the deferred bonus agreement, the Farmars received a payment of $257,653.90 in January 1976 (Stip. para. 24, J.A. 9). On his 1976 joint in-

come tax return, Philip Farmar reported $205,180.86 representing his share of the lease bonus. He deducted 22% of this amount as "Tentative Allowance Statutory Depletion-Bonus" on that return (Stip. paras. 25, 26, J.A. 9).

In 1976, oil and gas were discovered in six wells on the Irion property, and approximately 25,855 barrels of oil and 13,498,000 cubic feet of gas were produced (Stip. para. 31, J.A. 10). During that year, petitioners received royalties on this production, and Farmar and Sugg claimed a 22% depletion deduction of $5,867.64 and $14,141.32 respectively, on these amounts (Stip. Exh. D, sched. E; Stip. Exh. G, sched. E, P. III). The percentage depletion deductions claimed for these production royalties are not in question here (82-774 Pet. App. 2a n.2).

On audit, the Commissioner of Internal Revenue disallowed the percentage depletion deductions taken with respect to the bonuses. Petitioners paid the resulting deficiencies, and subsequently filed this consolidated suit for refund in the Court of Claims (82-774 Pet. App. 1a-2a). On cross-motions of the parties for summary judgment, the Court of Claims agreed with the Commissioner that petitioners were not entitled to the percentage depletion deduction with respect to the bonus payments received (*id.* at 16a). After examining Section 613A of the Internal Revenue Code, the court stated that "[t]his statutory language regularly linking depletion directly to production during a taxable year indicates to us that Congress wanted depletion to be allowable only 'with respect to' income derived from, or connected with, actual extraction during the taxable year" (82-774 Pet. App. 8a). The court concluded that petitioners "have not met the burden of showing that they are entitled to a deduction under § 613A—they have not convinced

us that the statute omits the requirement of a direct link to actual production for oil and gas income to be subject to the percentage depletion allowance" (*id.* at 16a).

SUMMARY OF ARGUMENT

1. Prior to the enactment of Section 501 of the Tax Reduction Act of 1975 (89 Stat. 47), which added Section 613A to the Internal Revenue Code, it was settled that the transferor of a mineral interest in consideration of a bonus or advance royalty was entitled to a percentage depletion allowance against such payments, whether or not there was mineral production in the year of payment. *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). But the Tax Reduction Act of 1975 changed this law. It generally repealed the percentage depletion allowance for oil and gas, effective January 1, 1975. See Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a) and (b)(1), 89 Stat. 47 and 53. Congress permitted a single exception to this repeal for independent domestic producers and royalty owners. Thus, Section 613A(c)(1) and (c)(1)(A) of the 1954 Code provides that percentage depletion "shall be computed in accordance with section 613 [allowing percentage depletion] with respect to * * * so much of taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed a specified depletable quantity. Section 613A(c)(1)(A) and (B). The "average daily production" is determined by dividing the aggregate production by the number of days in the taxable year.

Here, respondents in *Engle* and petitioners in *Farmar* assigned oil and gas leases respectively in consideration for advance royalties and lease bonuses that were not tied in any way to production. Under the 1975 change in the tax law, they were not entitled

to claim percentage depletion deductions on such payments.

The plain language of the statute convincingly refutes the decision below in *Engle* awarding percentage depletion, and supports the correctness of the Court of Claims' opposite holding in *Farmar*. The text of Section 613A(c)(1)(A) itself makes it clear that actual production is a prerequisite to any percentage depletion deduction for oil and gas. The statutory deduction is linked to "so much of the taxpayer's average daily production * * * as does not exceed the taxpayer's depletable oil quantity" (as set forth in Section 613A(c)(3)(B)). Where average daily production is zero, as here, the statutorily prescribed limitations (2,000 barrels for 1975) are obviously not exceeded, and multiplying any amount times zero equals zero. Without resort to legisaltive history or any other secondary material, the decision below is thus demonstrably wrong.

Surely, Congress did not use the term "average daily production" inadvertently. That term occurs in many places throughout the new provision. Section 613A(c)(1) and (c)(1)(A) requires that the oil and gas percentage depletion allowance be computed "with respect to" "the taxpayer's average daily production" of domestic crude oil or natural gas. The allowable depletable quantities are then defined in terms of production levels, and the applicable depletion rate and allowance are based on production during the particular taxable year. See Section 613A(c)(2), (3), (4), (5), (6), (7), (9) and (10). It is a reasonable inference that by using the term "production" in connection with the percentage depletion allowance, Congress intended to tie eligibility for that allowance to actual production during the taxable year. Indeed, the common meaning of "production" in connection

with minerals denotes physical extraction. As the Court of Claims observed: "The sheer fact is that, throughout § 613A(c) and (d), Congress repeatedly refers to 'production' of oil and gas, and frequently refers to said production for or during the 'taxable year,' in a way appearing to suggest that actual extraction was in mind" (82-774 Pet. App. 7a-8a).

2. Contrary to the reasoning of the court below in *Engle* (Pet. App. 15a), the fact that the foregoing statutory interpretation departs from the rule under prior law is not controlling. It is the very enactment of Section 613A in 1975 that radically changed the availability of and eligibility for percentage depletion. As the Court of Claims put it: "If the words of later legislation fit better with such a departure than they do with retention of prior law, new language should be accepted as written (if, as * * * is the case here, the legislative history does not indicate otherwise)" (82-774 Pet. App. 8a).

To the extent that the legislative history sheds light on the question, it supports our submission that eligibility for percentage depletion requires actual production during the taxable years. Section 613A was first proposed in 1974 as part of H.R. 17488, 93d Cong., 2d Sess. That bill, which likewise eliminated percentage depletion for oil and gas, contained an exception for small producers, and allowed them percentage depletion "with respect to so much of [a taxpayer's] average daily production of domestic crude oil as does not exceed 3,000 barrels." H.R. 17488, 93d Cong., 2d Sess. § 112(a) (1974). In a committee report on that bill, the House Committee on Ways and Means explicitly stated that the so-called "small producers" exemption was to be applied to "gross income attributable to a proportion of actual production." H.R. Rep. No. 93-1502, 93d

Cong., 2d Sess. 46 (1974). The Committee further stipulated that "a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions" (*ibid.*).

Although H.R. 17488 was never enacted into law, its provisions contain the general framework for the independent domestic producers exemption. It is apparent from the congressional debates on the final bill in 1975 (H.R. 2166, 94th Cong., 1st Sess.) that Congress was most concerned with the production of oil and gas. See 121 Cong. Rec. 4622-4652, 6903-6905, 7218-7229, 7238-7248, 7263-7285, 7772-7813, 8128-8129, 8860 (1975). Since the Committee Report on H.R. 17488 spelled out a production prerequisite for use of percentage depletion and the current statute follows the approach of the prior legislative proposal, the legislative history of H.R. 17488 represents some evidence that Congress intended actual extraction of the mineral during the taxable year to be a necessary element of the percentage depletion deduction. While the decision below in *Engle* gave no credit to the prior committee statement because it related to an earlier bill in an earlier Congress (Pet. App. 8a-11a), the Court of Claims properly regarded it as entitled to "some weight" "[i]n the absence of any real contradictory history" as "the only significant reference to the issue before us" (82-774 Pet. App. 13a, 70a). Indeed, in an analogous context, this Court has ascribed significance to the subsequent enactment of provisions originally contained in rejected legislative proposals. See *Gemsco, Inc* v. *Walling*, 324 U.S. 244, 246 n.4, 264 n.31, 265 n.33 (1945), and accompanying text.

3. Although it rejected the Commissioner's reading of Section 613A, the court below in *Engle* acknowledged that "both parties to this controversy [have advanced] * * * reasonable interpretations" (Pet. App. 11a). But in such a case, "[t]he choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler Dealers Association* v. *United States*, 440 U.S. 472, 488 (1979). Here, the Commissioner promulgated his interpretation two years after the enactment of Section 613A. Pursuant to the proposed regulations, which the decision below implicitly invalidated, percentage depletion requires actual production during the taxable year and therefore only oil or gas produced during the year can be taken into account. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967).

ARGUMENT

A TAXPAYER IS NOT ENTITLED TO PERCENTAGE DEPLETION DEDUCTIONS FOR PAYMENTS WHICH ARE NOT ATTRIBUTABLE TO OIL OR GAS PRODUCTION

A. The 1975 Act changed the tax law to condition the percentage depletion deduction upon actual production of oil or gas during the taxable year

These consolidated cases present an important question with respect to the tax treatment of advance royalties or lease bonuses paid to owners of oil and gas leases. Section 611(a) of the Internal Revenue Code of 1954 (26 U.S.C.) (Pet. App. 74a) provides that in the case of mineral deposits (including oil and gas wells), "there shall be allowed as a deduc-

tion in computing taxable income a reasonable allowance for depletion * * *." The deduction is allowed only to the owner of an economic interest in the mineral deposits. Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.611-1(b)(1). Until 1975, the amount of the deduction was computed on the basis of either a percentage depletion allowance [8] pursuant to Section 613 or a cost depletion allowance [9] pursuant to Section 612. Percentage depletion was computed with respect to "gross income from the property" at rates ranging from 22% for substances such as sulphur, and uranium to 14% for borax, marble, and other substances. See Section 613(b).

Prior to the Tax Reduction Act of 1975, it was well established that where the owner of a mineral deposit leased it to another in consideration of an

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[8] In computing percentage depletion with respect to oil and gas, under the prior law, the owner included in his gross income only the proceeds of the oil and gas which he might retain. The gross income was then multiplied by a prescribed percentage, "the depletion allowance," to obtain the amount of the deduction. See *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312 (1934). This depletion deduction was then limited by statute to 50% of the taxpayer's "taxable income from the property." Section 613(a). The percentage depletion was not dependent upon the existence of a tax basis in the economic interest, but might be taken even after the taxpayer had recouped his capital investment. See *Commissioner* v. *Rowan Drilling Co.*, 130 F.2d 62 (5th Cir. 1942). See also *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (1946).

[9] Cost depletion is computed generally in the following manner:

$$\frac{\text{Number of units sold during the year}}{\text{Estimated recoverable reserves}} \times \text{Cost of mineral interest}$$

See Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.611-2(a).

initial bonus or of advance royalties, the bonus and advance royalties constituted "gross income from the property" and were depletable income to the owner. The bonus was regarded as "payment in advance for oil and gas to be extracted," and was eligible for the allowance for depletion. *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). The advance royalty payment was a "return *pro tanto* of [the lessor's] capital investment in the oil in anticipation of its extraction * * *." *Palmer* v. *Bender*, 287 U.S. 299, 302 (1932); *Burnet* v. *Harmel*, 287 U.S. 103 (1932).

Accordingly, taxpayers were entitled to a deduction for the greater of the percentage depletion allowance or the cost depletion allowance on gross income from oil and gas properties. *Herring* v. *Commissioner*, *supra*. They were entitled to this deduction whether or not there was production of the mineral property, because the emphasis was on the income received from the property, and not on the production of the substance itself. See 293 U.S. at 327-328. Even under the pre-1975 law, however, if a taxpayer received an advance payment, and no oil or gas was ever produced, he was required to recapture the depletion deduction and restore the previously deducted amount to income. *Douglas* v. *Commissioner*, 322 U.S. 275, 285 (1944); *Sneed* v. *Commissioner*, 119 F.2d 767, 771 (5th Cir.), cert. denied, 314 U.S. 686 (1941). In *Douglas*, this Court recognized the nexus between extraction and depletion, noting that "[t]o grant irrecoverable depletion in circumstances where cancellation of the lease occurs prior to extraction would sever depletion from extraction * * *." 322 U.S. at 284. Thus, actual production of oil and gas, current or future, has always been an inherent requisite for the depletion allowance (see Pet. App. 29a).

The Tax Reduction Act of 1975 represented a drastic change in the law concerning percentage depletion for most oil and gas producers. As the court of appeals below in *Engle* acknowledged (Pet. App. 4a), the 1975 Act generally repealed the percentage depletion allowance for oil and gas effective after December 31, 1974. See Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a) and (b)(1), 89 Stat. 47 and 53; 26 U.S.C. 613(d). There were two exceptions. Under the first exception, not relevant here, natural gas sold under a fixed contract or subject to federal price controls is still eligible for percentage depletion. See Section 613A(b). Under the second exception, independent producers are allowed a deduction for percentage depletion for a limited amount of production during the taxable year from wells located within the United States. Section 613A(c). Section 613A(c)(1) allows percentage depletion with respect to (emphasis supplied):

> (A) so much of the taxpayer's *average daily production* of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and
>
> (B) so much of the taxpayer's *average daily production* of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity.

A taxpayer's "average daily production" of oil or gas is determined "by dividing his aggregate production * * * during the taxable year by the number of days in such taxable year * * *." Section 613A(c)(2)(A).[10] The "depletable oil quantity," or

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[10] For partial interests in oil and gas properties, a taxpayer's production is determined "by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property." Section 613A(c)(2)(B).

maximum amount of allowable production, is 2,000 barrels of oil per day for 1975 and 1,800 barrels for 1976.[11] Section 613A(c)(3)(B). The percentage depletion rate for eligible production remains at 22% through 1980, and then gradually is reduced annually to 15% through 1984. Section 613A(c)(5).

Both before and after 1975, Section 613 of the 1954 Code was the statutory provision that permitted, to the extent there specified, a deduction based upon percentage depletion. As amended by the Tax Reduction Act of 1975, Section 613(d) made Section 613 inapplicable to any gas or oil well except as provided in the contemporaneously enacted Section 613A. Section 613A(a) repeats the inapplicability of Section 613 to oil and gas wells, except as provided in Section 613A(b) and Section 613A(c). Section 613A(b), dealing with certain gas wells, is concededly inapplicable to this case. Hence, Section 613A(c) is the only relevant exception to the newly enacted rule that Section 613, the source of the percentage depletion deduction, shall be inapplicable to oil and gas wells.

In the instant cases, the taxpayers received payments that were not based on the actual production of oil and gas during the taxable year. In 1975, the Engles received advance royalties of $7,600 for two leases from which there was no production during the taxable year (Pet. App. 17a-19a). For 1976, the Farmars and Sugg received lease bonuses total-

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[11] For years after 1976, the maximum amount of production decreased by 200 barrels per year, until it became a permanent limit of 1,000 barrels in 1980. Section 613A(c)(3)(B). For natural gas, 6,000 cubic feet is deemed to be equivalent to a barrel of oil. Section 613A(c)(4) and (8)(D)(iv).

ling $733,452.66 (Stip. paras. 11, 24, J.A. 7, 9).[12] As we shall now show, the plain language of the statute forecloses percentage depletion deductions with respect to such royalties or bonuses because they were not paid "with respect to" the actual production of oil or gas.

B. The plain language of Section 613A of the Code precludes a claim of percentage depletion with respect to lease bonuses or advance royalties that are not based upon production of oil and gas during the taxable year

1. The plain language of Section 613A makes it clear that actual production during the taxable year is a prerequisite to any depletion for oil and gas. The statute provides that percentage depletion "shall be computed in accordance with section 613 [allowing percentage depletion] with respect to—(A) so much

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[12] A royalty may be defined as " 'a right to the oil and gas in place that entitles its owner to a specified fraction, in kind or value, of the total production from the property free of the expense of development and operation.' " C. Breeding & A. Burton, *Income Taxation of Oil and Gas Production* § 203 (quoted in *Getty Oil Co.* v. *United States*, 399 F.2d 222, 225 (Ct. Cl. 1968)). An advance royalty may or may not be chargeable against the royalty owner's share of future production. C. Breeding & A. Burton, *supra*, § 203.

A lease bonus is generally the cash consideration paid by the lessee for the execution of an oil and gas lease by the landowner. H. Williams & C. Meyers, *Oil and Gas Terms* 50 (4th ed. 1976). See also *Shamrock Oil & Gas Corp.* v. *Commissioner*, 35 T.C. 979, 1040 (1961). A bonus is generally figured on a per acre basis. H. Williams & C. Meyers, *supra*, at 50. For federal income tax purposes, cash bonuses prior to 1975 have been treated as advance royalties which were eligible for the percentage depletion deduction. *Anderson* v. *Helvering*, 310 U.S. 404, 409 (1940); *Burnet* v. *Harmel*, 287 U.S. 103 (1932).

of the taxpayer's average daily production" of domestic oil or natural gas as does not exceed a specified depletable quantity. Section 613A(c)(1)(A) and (B). "Average daily production" is aggregate production during the taxable year, divided by the number of days in that taxable year. Section 613A(c)(2).

Surely, Congress did not inadvertently use the term "average daily production" and define it in terms of production "during the taxable year", as even the court below in *Engle* apparently recognized (see Pet. App. 11a). Those terms are employed throughout the new provision. Thus, Section 613A(c)(1) and (c)(1)(A) requires that the oil and gas percentage depletion allowance be computed "with respect to" the taxpayer's average daily production" of domestic crude oil or natural gas. The allowable depletable quantities are then defined in terms of production levels, and the applicable depletion rate and allowance are based on production during the particular taxable year. See Section 613A(c)(2), (3), (4), (5), (6), (7), (9), and (10). The court in *Engle* acknowledged that the charts showing maximum production "suggest that Congress was focusing on actual production during the taxable year for which the depletion allowance was claimed" (Pet. App. 11a).

Moreover, the very use of the term "during the taxable year" throughout Section 613A emphasizes the link between actual production and income. As the Court of Claims noted in *Farmar* (82-774 Pet. App. 64a n.6), subsection (c)(2) deals with the taxpayer's average daily production "for any taxable year." Production "for the taxable year" and "for any taxable year" is again mentioned in subsections (c)(3)(A)(ii) and (c)(4), respectively. Subsection (c)(5)

likewise deals with "production during the calendar year." See also Section 613A(c)(6), (7), (9), and (11). Finally, oil production is measured by "barrels", defined to mean 42 United States gallons. Section 613A(e)(4).

It is a necessary inference that by using the term "average daily production" defined in terms of production "during the taxable year" in connection with the percentage depletion allowance, Congress intended to tie eligibility for the allowance to actual production during the taxable year. Indeed, the common meaning of "production" in connection with minerals denotes physical extraction. In the parlance of the oil and gas field, the term "production" means marketable oil or gas. *Rogers* v. *Osborn*, 152 Tex. 540, 541-542, 261 S.W.2d 311, 312 (1953). See also *Monsanto Co.* v. *Tyrrell*, 537 S.W.2d 135, 137 (Tex. Civ. App. 1976) ("production" has "a definite legal meaning, namely, the actual physical severance of the mineral from the soil"). See generally H. Williams & C. Meyers, *Oil and Gas Terms* 454-455 (4th ed. 1976). As the Court of Claims observed in *Farmar*: "The sheer fact is that, throughout § 613A(c) and (d), Congress repeatedly refers to 'production' of oil and gas, and frequently refers to said 'production' for or during the 'taxable year,' in a way appearing to suggest that actual extraction was in mind" (82-774 Pet. App. 7a-8a). Accord: Bravenec, *Continued Availability of Percentage Depletion of Oil and Gas*, 23 Oil & Gas Tax Q. 204, 211 (1975). Contrary to the court of appeals' view in *Engle* (see Pet. App. 6a), the language of the statute, with its emphasis on production, is not ambiguous.

2. Given the plain meaning of the statutory language employed by Congress, there is no basis for the court's construction in *Engle* (see 82-774 Pet.

App. 6a) that Section 613A turns on sales or income received, instead of production. See Bravenec, *supra*, 23 Oil & Gas Tax Q. at 211. In other portions of Section 613A, there are explicit references made to "sales" of natural gas. See, *e.g.*, Section 613A(b)(2)(A) ("domestic natural gas sold by the producer"); Section 613A(b)(2)(B) (" 'regulated natural gas' means domestic natural gas produced and sold by the producer"). In using the term "average daily production", defined in terms of production "during the taxable year," in the independent producer's exemption, Congress intended the percentage depletion deduction to be based on just that—production—not sales or, even more broadly, income. See *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 560 (1932) (words are to be given their common and ordinary meaning); *Tabor* v. *Ulloa*, 323 F.2d 823, 824 (9th Cir. 1963) (a legislature is presumed to have used no superfluous words). As a leading commentary has observed, the language of Section 613A "strongly supports the premise that actual production is a necessary requirement for the availability of percentage depletion." F. Burke, Jr. & R. Bowhay, *Income Taxation of Natural Resources* ¶ 832, at 856 (1982). See also K. Orbach, T. Dickens & K. Fields, *A Percentage Depletion Allowance Alternative to* Engle *and* Glass, 31 Oil & Gas Q. 255, 268-269 (1982).

This emphasis on production in Section 613A is not merely a limitation on the allowance of percentage depletion, as the court of appeals in *Engle* presumed (Pet. App. 15a), but is an essential prerequisite to the deduction. As the Court of Claims noted in *Farmar* (82-774 Pet. App. 10a), "[f]or us to read subsection (c) merely as imposing a top limitation, without regard to the amount of actual production, is to

degrade the specific words Congress consistently used when it added § 613A to the law." The exception set forth in Section 613A(c) to the denial of percentage depletion applies only with respect to the actual production of oil or gas. *Glass* v. *Commissioner*, 76 T.C. 949, 952 (1981). In the Tax Court's view, this language is "so clear that it allows no leeway to 'impute production' as [taxpayers] would have us do, to their bonuses [and advance royalties] so that they can qualify for percentage depletion deduction with respect thereto" (*id.* at 957). Indeed, under the reading of the statute of the court below in *Engle*, Section 613A(c)(1) and (c)(2) might as well be omitted, with only subsection (c)(3) serving to impose a limitation on the amount of the percentage depletion deduction during any taxable year. What is more, even subsection (c)(3) makes reference to production "for the taxable year" in subsection (c)(3)(A)(ii) and to production "during the calendar year" in subsection (e)(3)(B).

3. Contrary to the reasoning of the court of appeals in *Engle* (Pet. App. 15a), the fact that the foregoing statutory interpretation departs from the rule applicable under prior law does not dictate the result reached below in that case. The very fact that the legislature enacts an amendment indicates that it intended to change the original law by creating a new right or withdrawing an existing one. 1A C. Sands, *Sutherland Statutory Construction* § 22.30, at 178 (4th ed. 1972). Here, it is the very enactment of Section 613A in 1975 that radically changed the availability of, and eligibility for, percentage depletion for oil and gas.

The Section 613A(c) exception to the general repeal of oil and gas percentage depletion is based primarily on production, and production "during the tax-

able year," *i.e.*, on average daily production of oil (Section 613A(c)(1)(A)) and average daily production of gas (Section 613A(c)(1)(B)), with upper limits stated in absolute amounts in Section 613A(c)(3)(B). This is the logical intepretation of the statutory language (see Pet. App. 66a). As the Court of Claims stated in *Farmar* (82-774 Pet. App. 8a), "[i]f the words of later legislation fit better with such a departure than they do with retention of prior law, new language should be accepted as written (if, as * * * is the case here, the legislative history does not indicate otherwise)." [13]

In sum, the Engles are not eligible for percentage depletion because (a) they had zero average daily production during the taxable year for which percentage depletion was to be computed, and (2) zero production times the applicable percentage depletion rate (22%) equals zero. Without resort to legislative history or any other secondary material, the decision below in *Engle* is demonstrably wrong.

It is not "absurd," as the court in *Engle* apparently thought (Pet. App. 11a), to require physical extraction as a prerequisite to the percentage depletion deduction. Production *during the taxable year*, which the statute requires, can be computed on no other basis. The court of appeals stated (*ibid.*) that under the Commissioner's interpretation, "the Engles might have claimed the depletion allowance had one barrel of oil been produced from the leased properties during 1975." Indeed, under the Commissioner's reasoning,

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[13] Indeed, as the Court of Claims noted in *Farmar* (82-774 Pet. App. 11a-13a), the House report, which specifically stated that the percentage depletion deduction was no longer applicable to lease bonuses, did not address the viability of *Herring* v. *Commissioner*, *supra*. See H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 46 (1974). See also *infra* pp. 25-27.

if one barrel had been produced during 1975, the Engles would have been entitled to percentage depletion—but only on that one barrel. See Proposed Treasury Regulations on Income Tax, Section 1.613A-7(f), 42 Fed. Reg. 24287 (1977).

The facts in *Farmar* amply illustrate this principle. There, the taxpayers received royalties (based on production) and lease bonuses in 1976 (Stip. paras. 8, 20, J.A. 6, 8). The Commissioner allowed the taxpayers to claim percentage depletion deductions based on the royalties received (J.A. 9, 11). He disallowed, however, the percentage depletion deductions based on the lease bonuses, because the bonuses were not paid "with respect to" the "average daily production" of oil or gas "during the taxable year." Section 613A (c)(1)(A). Far from being "absurd," the difference in treatment is consisent with Congress' emphasis in Section 613A on production during the taxable year. See K. Orbach, T. Dickens & K. Fields, *supra*, 31 Oil & Gas Tax Q. at 274.

C. The legislative history of Section 613A supports the Commissioner's interpretation

1. To the extent that the legislative history of Section 613A sheds any light on this issue, it supports the Commissioner's position that advance payments must be based on actual production of oil or gas during the taxable year, and production "during the taxable year."

The substance of Section 613A was first proposed in 1974 in H.R. 17488, 93d Cong., 2d Sess., as part of the Energy Tax and Individual Relief Act of 1974. Although H.R. 17488 never became law, the basic framework for the independent producers exemption was contained in the bill. H.R. 17488 would have allowed

percentage depletion at a rate of 15% to be taken on the first 3,000 barrels of oil production per day. The successor to the bill, H.R. 2166, became the Tax Reduction Act of 1975, which contained a more stringent definition of a small producer, and allowed depletion in 1975 on only 2,000 barrels per day during the calendar year, reduced to 1,000 barrels in 1980. See 1975 Act, Section 501(a) (89 Stat. 47). As originally introduced in the House, the bill which led to the 1975 Act (H.R. 2166) did not affect the percentage depletion allowance. A floor amendment was added in the House that would have generally repealed the percentage depletion allowance for oil and gas. 121 Cong. Rec. 4651-4652 (1975). When the bill reached the Senate floor, the Senate added an amendment to provide for a limited exemption for independent producers and royalty owners. 121 Cong. Rec. 7813 (1975). The Senate amendment, altered from a 3,000 barrel limitation to the 2,000 barrel phased-down limitation in the Conference Committee, became Section 613A(c).

As the Court of Claims pointed out in *Farmar* (82-774 Pet. App. 11a), there was no floor discussion or statement in the conference reports directly bearing on the question presented here. There was, however, a reference to the problem in the immediately preceding Congress. In 1974, the House originally proposed (in H.R. 17488) to repeal the percentage depletion allowance for oil and gas, with an exemption for small producers, because it concluded that "the price level now applicable in the case of oil no longer justifies the continuance of the percentage depletion tax incentive. The rise in the price of oil itself should provide all of the incentive needed in the period ahead to

explore and develop our energy resources." H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 45 (1974).

In its report on H.R. 17488, the House Committee stated that it intended the independent producers' exemption to apply only to the production of oil and gas, and not to the income from the property, as under the old law. The report stated (H.R. Rep. No. 93-1502, *supra*, at 46; emphasis supplied):

> The small production exemption applies to gross income attributable to a proportion of *actual production*, and the stripper well and North Slope exemptions apply only to oil produced from specifically identifiable sources. Thus, the 15 percent rate applies to gross income attributable to oil which is sold or removed from the premises and not to other types of depletable income. *For example, a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions.* Such payments are subject to the general phaseout.

Although this excerpt is not part of the report on the final bill, it is an important part of the background against which the parallel 1975 Act was passed. As this Court has noted, "the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part." *Helvering* v. *Morgan's Inc.*, 293 U.S. 121, 126 (1934). The court of appeals in *Engle* erroneously declined to consider the import of this House report (see Pet. App. 8a-9a), since, as the

Court of Claims noted (82-774 Pet. App. 11a, 13a), H.R. 17488 was very similar to Section 613A, and the House report is the only significant reference to the issue now before the Court. Indeed, in an analogous context, this Court has ascribed significance to the subsequent enactment of provisions originally contained in rejected legislative proposals. See *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 246 n.4, 264 n.31 (1945), and accompanying text.

2. As the Court of Claims noted in *Farmar* (82-774 Pet. App. 11a-13a), the congressional debates also indicate that percentage depletion must be based on current production.[14] It is clear from the House and

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[14] The congressional statements on H.R. 2166 strongly support the Court of Claims' conclusion (82-774 Pet. App. 11a-13a) that Congress relied on the House's consideration of H.R. 17488 as the groundwork for the final bill. Senator Bentsen, who introduced one of the amendments to H.R. 2166 in 1975, see 121 Cong. Rec. 7277 (1975), referred to the House Report on H.R. 17488 in hearings before the Senate Finance Committee:

> This amendment [a 3,000 barrel per day limit for small producers] is simply an embodiment of the recommended reform of percentage depletion contained in the congressional program of economic recovery and energy efficiency adopted in February of this year. The 3,000 barrel per day figure was chosen by the House Ways and Means Committee as a definition of a small producer after extensive consideration last year.

Hearings on H.R. 2166 Before the Subcomm. on Energy of the Senate Comm. on Finance, 93d Cong., 2d Sess. 2 (1975).

During the Senate debates on H.R. 2166, Senator Bentsen also referred to the report stating "I think, again using the 3,000 barrel a day figure adopted by the [House] Ways and Means Committee last year for oil, that we are allowing depletion on gross income of a little over $8 million annually

Senate debates that in 1975 Congress was most concerned with the production of oil and gas and whether the percentage depletion allowance would encourage further exploration.[15] The debate considered proposals ranging, on the one hand, from a complete repeal of the percentage depletion allowance, see 121 Cong. Rec. 4600-4659 (1975), to a small producers' exemption of 3,000 or 1,000 barrels of oil production per day. *Id.* at 7799 (remarks of Sen. Humphrey). As one Senator stated, the discussion concerned "what we should have as a level of oil production in order to

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* * *." 121 Cong. Rec. 7777 (1975). See also 121 Cong. Rec. 7278 (1975): "The amendment before us is one that would limit the depletion allowance for the first 3,000 barrels of average daily production of crude oil * * * which is the limitation voted on in the House of Representatives." See also 121 Cong. Rec. 4646, 6903 (1975).

[15] See, *e.g.*, 121 Cong. Rec. 4606 (1975) (remarks of Rep. Rhodes) ("I think we should all recall that one of the reasons for this bill being brought here with some haste is the fact that we have a shortage of domestic petroleum"); *id.* at 4631 (remarks of Rep. Ashley) ("Exploratory drilling for oil in the United States has declined more than 50 percent over the past 15 years, in spite of a depletion allowance that costs the Treasury approximately $3 billion a year in lost revenues."); *id.* at 7807 (remarks of Sen. Curtis) ("Our first objective should be the production of more gas and oil."); *ibid.* (remarks of Sen. Bartlett) ("I think it is important that we face up to the American people and say that this body has done next to nothing to increase the production of natural sources of energy in this country in the last 2 years plus that I have been in the Senate * * *."); *id.* at 8944 (remarks of Rep. Pickle) ("In this time of national energy crisis, what we need—desperately—is more production."); *id.* at 8128 (remarks of Sen. Dole) ("The 2,000-barrel * * * exemption from the depletion allowance repeal is vitally important to maintaining a high level of energy exploration and production.").

retain the depletion allowance * * *." *Id.* at 7795 (remarks of Sen. Tunney).

When Congress enacted the Tax Reduction Act of 1975, it almost entirely eliminated, in Section 613A (a), the percentage depletion deduction for the production of oil and gas. The final provision was a compromise measure between the House bill, eliminating percentage depletion entirely for all oil and gas, and the Senate version, containing the independent producers' exemption for those whose average daily production did not exceed 2,000 barrels. See H.R. Conf. Rep. No. 94-120, 94th Cong., 1st Sess. 67 (1975), *reprinted in* 1975-1 Cum. Bull. 629-630. The Conference Committee report stated (*ibid.*; emphasis supplied):

> Under the Senate amendment, the deduction for percentage depletion is generally eliminated with respect to oil and gas produced on or after January 1, 1975, with certain exceptions. These include the exceptions provided under the House bill. In addition, the Senate amendment *retains* percentage depletion at 22 percent on a permanent basis for the small independent producer to the extent that his average daily production of oil does not exceed 2,000 barrels a day, or his average daily production of natural gas does not exceed 12,000,000 cubic feet. Where the independent producer has both oil and natural gas production, the exemption must be allocated between the two types of production.

The Conference Committee's use of the word "retains" does not, in the overall legislative context, imply that the entire pre-existing body of case law for percentage depletion was to be retained for independent producers. It is apparent from the congressional debates and the House report on the predecessor of

the 1975 Act that Congress was chiefly concerned with finding new ways to encourage the production of oil and gas. Implicit in the Conference Committee's language is the idea that the percentage depletion allowance was to be given to those producers who had actual production during the taxable year. In the same report, the Committee later stated (H.R. Conf. Rep. No. 94-120, *supra*, at 68 (1975-1 Cum. Bull., *supra*, at 630); emphasis supplied):

> The conference substitute follows the Senate amendment in providing a small producer exemption from the repeal of percentage depletion for oil and gas. *Initially the exemption* ("depletable oil quantity") *is 2,000 barrels of average daily production* (or 12,000,000 cubic feet of natural gas). * * *
>
> However, under the substitute, a taxpayer will be permitted to take percentage depletion, at a 22 percent rate, on all production resulting from secondary or tertiary recovery methods until 1984 (but not in excess of 1,000 barrels per day).

As one of the House conferees explained before the passage of the 1975 Act, the compromise measure provided "a scheduled reduction in barrels of *daily oil production eligible* for 22 percent depletion which goes down to 1,000 barrels." 121 Cong. Rec. 8924 (1975) (remarks of Rep. Vanik; emphasis added). During its second session, the 94th Congress recognized the need for production in order to qualify for the percentage depletion deduction when the Senate Finance Committee was considering certain technical changes in Section 613A.[16] See Senate Comm. on Finance,

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[16] While not part of the legislative history of Section 613A, this subsequent report is entitled to consideration as a secon-

Tax Reform Act of 1976, S. Rep. No. 94-938, 94th Cong., 2d Sess. 424 (1976), *reprinted in* 1976-3 (Vol. 3) Cum. Bull. 462. In its discussion of the Tax Reduction Act of 1975, the Senate committee stated (*ibid.*; emphasis added):

> Under the other exception (the "small producer exemption"), percentage depletion is allowed for a limited amount of *production* from wells located within the United States. *The amount of production eligible* for percentage depletion is an average of 2000 barrels per day (or its equivalent in cubic feet of gas) for 1975 and phases down to an average of 1000 barrels per day (or its equivalent in cubic feet of gas) for 1980 and thereafter.

Accord: Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976* (*H.R. 10612*), 1976-3 (Vol. 2) Cum. Bull. 636.

This interpretation is required by Section 613A's definition of "average daily production." The average is determined by dividing the total production of oil and gas "during the taxable year" by the number of days in that year. Section 613A(c)(2)(A). This definition of "average daily production" is the same definition proposed in H.R. 17488, in 1974.[17] See H.R.

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darily authoritative expression of expert opinion. *Bobsee Corp.* v. *United States*, 411 F.2d 231, 237 n.18 (5th Cir. 1969).

[17] The pertinent provisions of H.R. 17488, *supra*, § 112 provided:

> (b) 3,000 BARREL-A-DAY EXEMPTION.—
>
> (1) IN GENERAL.—If the taxpayer elects the application of this subsection for the taxable year, then with respect to so much of his average daily production

17488, *supra*, § 112. Since the House committee report on H.R. 17488 specifically spelled out a production prerequisite, it is clear that Congress intended actual extraction of the mineral "during the taxable year" to be a necessary element of the percentage depletion deduction.

3. Finally, the proposed regulations [18] under Section 613A implement Congress' intent to base the percentage depletion deduction on production. Under the proposed regulations, which were published in the Federal Register on May 13, 1977, only oil or gas produced during the taxable year shall be taken into account. Proposed Regulations on Income Tax, Section 1.613A-7(f)(1), 42 Fed. Reg. 24287 (1977) (Pet. App. 83a-84a). Advance royalties and lease bonuses, "while taken into account for purposes of sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A (c)." *Ibid.* See also *id.* Section 1.613A-3(a)(4), Exh. (4), 42 Fed. Reg. 24281 (1977) (Pet. App. 81a-82a). These proposed regulations are relevant as an

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of domestic crude oil as does not exceed 3,000 barrels, the percentage referred to in section 613(a) shall be 15 percent in the case of gross income from the property before January 1, 1979.

(2) AVERAGE DAILY PRODUCTION.—For purposes of paragraph (1), the taxpayer's average daily production of domestic crude oil shall be determined by dividing his aggregate production of domestic crude oil during the taxable year by the number of days in such taxable year.

[18] The Regulations under Section 613A are still in proposed form because the Internal Revenue Service is in the process of resolving questions that do not involve the statutory construction question presented in these cases.

indication of administrative practice (see Pet. App. 72a). See also Rev. Rul. 81-44, 1981-1 Cum. Bull. 384, and *Glass* v. *Commissioner*, *supra*, holding that lease bonuses are not eligible for percentage depletion.

Although it rejected the Commissioner's reading of Section 613A, the Seventh Circuit acknowledged that "both parties to this controversy [have advanced] * * * reasonable interpretations" (Pet. App. 11a). But in such a case, "[t]he choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler Dealers Association* v. *United States*, 440 U.S. 472, 488 (1979). Here, the Commissioner promulgated his statutory interpretation two years after the enactment of Section 613A. Pursuant to the proposed regulations, which the *Engle* decision implicitly invalidated, percentage depletion requires actual production during the taxable year and therefore only oil and gas produced during the year can be taken into account. This administrative practice—representing a contemporaneous construction of the statute by those charged with its enforcement—is entitled to considerable deference, especially where the statutory language is in accord with the Commissioner's interpretation. *Bingler* v. *Johnson*, 394 U.S. 741, 749-750 (1969). As this Court has stated, "[t]he role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967). The statutory language and legislative history of Section 613A support our submission that the percentage depletion allowance be based on production, not income. Hence, for years after 1974 in which there is an advance payment (either by lease bonus or royalty) with no production of oil and

gas from the properties, the lease holders are not entitled to percentage depletion deductions with respect to such payments.

CONCLUSION

The judgment of the court of appeals in *Engle* (No. 82-599) should be reversed; the judgment of the Court of Claims in *Farmar* (No. 82-774) should be affirmed.

Respectfully submitted.

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